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## Infrastructure Financing That Works and We Can Afford

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By William H. Wood

Here are two incontrovertible facts: the municipal bond market is a mess, and the president being sworn in today has determined that our nation needs to use public resources to fund large-scale public works projects as part of a broad-based economic recovery program.

Using some of that federal authority to remedy the current dislocations in the municipal bond market - without simultaneously creating a bloated federal bureaucracy - would go a long way toward responsibly meeting the goal of facilitating new infrastructure investment.

Tax-exempt municipal bonds have, after all, been the extraordinarily successful vehicle behind roughly a century of state and local governmental public finance.

The program proposed here not only should help to stabilize the municipal bond market, but with a little luck it should do so at no cost to federal taxpayers. Finally, the program should, by design, disappear once market conditions return to normal.

Let's start by reviewing the state of the municipal bond market.

Fixed rate municipal bond yields are at near record spreads to Treasuries: as of Thursday, the 30-year triple-A Municipal Market Data rate stood at 4.74%, 188 basis points above the 30-year Treasury yield of 2.86%. Historically, of course, the triple-A MMD rate has almost always been well below the corresponding Treasury yield.

The story is worse for a 30-year A-rated revenue bond: its spread to Treasuries is 292 basis points. Moreover, market access, even at those levels, has been far from assured, especially for large borrowings.

Outstanding variable-rate programs have been hard-hit: insurer downgrades have crippled issuers with outstanding auction-rate securities as well as certain variable-rate demand bonds. Direct-pay letters of credit are almost impossible to find and the prices for those that are available are through the roof. Meanwhile, standby letters of credit are no longer sufficient for many issuers to market their variable-rate paper at attractive rates.

Finally, there are all those derivatives contracts America's municipal issuers have on their books. The most common are interest rate swaps.

Unfortunately, these contracts are now (1.) failing to hedge actual variable-rate interest costs, (2.) subject to collateral calls due to insurer downgrades, and (3.) subject to costly termination either if the issuer chooses to unwind them as part of a fixed-rate refinancing or if the swap provider ceases doing business.

Before the meltdown, swaps were a favorite product of investment bankers because of a greater potential for profit both at inception and over time as restructuring opportunities arose.

In most cases, issuers also benefited from significantly lower borrowing costs, but as we see today, significant risks were ignored or underestimated by both bankers and issuers.

Many governmental entities across the nation are now paying far more in interest on a large portion of their outstanding debt than they had budgeted for just 12 months ago. The consequence of this added interest expense, especially when combined with the reduction in revenues many municipalities are experiencing as the recession settles in, is that there are fewer funds available for funding capital projects of any kind.

Against this depressing backdrop stands the promise that President Obama intends to support a massive federal investment in new infrastructure projects. Cleaning up the ravaged variable-rate debt that sits on the balance sheets of this country's municipal borrowers seems like a pretty good way to begin this process. Insuring that existing state and local governmental borrowers have access to low-cost, fixed-rate funding for targeted new capital projects seems a good way to stimulate new capital investment.

Assuming the market dislocation which has left triple-A muni rates well above Treasury rates continues, an important part of the solution could come from a new and temporary federal agency, a State and Local Government Financing Authority.

The SLGFA would be empowered to buy fixed-rate, investment-grade bonds from municipal issuers at spreads carefully structured to include a risk premium above the prevailing taxable rates on Treasury bonds.

An issuer's borrowing cost would be determined by adding the spread to those rates which the Treasury already publishes on a daily basis for its State and Local Government Series securities program. The Treasury would then sell conventional taxable debt to the public to fund the purchase of these bonds using a matched duration.

By design, the SLGFA program should insure that market forces will lead otherwise qualified borrowers to return to traditional, lower cost tax-exempt debt issuance once traditional market relationships between municipal and Treasury debt resume.

Since tax-exempt yields for investment-grade borrowers are likely to be lower than risk-adjusted taxable yields under normal market conditions, the formula proposed should - assuming the risk premium charged is high enough - insure that borrowers will stop using the authority for their financing needs once the municipal market has stabilized.

In order to insure that the SLGFA functions primarily as a short-term stimulus program, its lending authority needs to be restricted to the most important and worthwhile financings.

This authority should, however, include giving state and local governmental borrowers a mechanism for converting outstanding variable-rate debt programs to long-term, low-interest, fixed-rate bonds (while collapsing and paying down any derivatives contracts associated with such outstanding debt), and funding major capital construction projects that meet the goals established for producing a material and immediate stimulus to the national economy.

How would this program work in practice? Let's assume a highly simplified example in which an A-rated highway agency wants to raise \$500 million for an approved project by selling non-amortizing 30-year bonds. Let's further assume that the risk premium for this A-rated issuer is set at 50 basis points above Treasury SLGS rates. Given that the 30-year SLGS rate currently stands at 2.95%, our hypothetical highway agency would be able to sell their bonds directly to SLGFA at a taxable rate of 3.45%. The lowest of MMD's 30-year tax-exempt revenue bond yields is 5.78%.

In this market scenario, using the SLGFA would be likely to save a borrower 233 basis points in annual interest expense or at least \$349 million over the next 30 years. And unlike conventional municipal bonds which carry an implicit federal subsidy because of their tax exemption, debt issued under this program would - assuming no unusual default levels - be net cash flow positive for the Treasury, which would not only keep the risk premium on each loan it acquired but also collect taxes on the interest on a portion of the conventional Treasury debt issued to fund the SLGFA loan purchases.

Will President Obama recognize the centrality of the tax-exempt municipal bond market to his admirable goals for rebuilding our nation's infrastructure? Will he also recognize that a program that quickly helps to restore affordable market access for municipal borrowers is the best and least bureaucratic way to jump-start the economic development he wants to encourage?

We will find out in just a few weeks time if the man who ran for president with the slogan of "change we can believe in" also understands the importance of change that works and change we can afford.

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